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Economic development in Africa: Catalysing investment for transformative growth in Africa

Overview

Executive summary

Investment is a major driver of long-run growth and development. It is necessary to build productive capacities, transform the structure of economies, generate employment and reduce poverty. Over the past decade, African countries have had relatively good economic growth performance. However, average investment rates on the continent remain low relative to what is considered necessary to achieve national development goals. They are also low relative to the average rate for developing countries. These facts suggest that Africa's recent growth may be fragile and that it is unlikely to be sustained in the medium to long term if current trends continue. The key question, then, is how can African governments catalyse investment for sustained and transformative growth? The *Economic Development in Africa Report 2014: Catalysing Investment for Transformative Growth in Africa* addresses this issue. It underscores the need to enhance the contribution of investment to growth by boosting investment rates, improving the productivity of existing and new investments and ensuring that investment goes to strategic and priority sectors deemed crucial for economic transformation. It also stresses the importance of strengthening linkages between local and foreign enterprises, stemming capital flight to release more resources for investment, using aid to stimulate investment and fostering international trade to raise investment. In each of these areas, the Report emphasizes the need for policy coherence at the national and international levels.

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Introduction

1. Africa entered the twenty-first century on a very good note. The economic growth performance of most African countries over the past decade has been good relative to the continent's historical growth performance and the average growth rate for the global economy. Despite Africa's recent growth performance, there are indications that countries on the continent are experiencing the wrong type of growth in the sense that joblessness is still widespread and growth has not led to significant reductions in poverty. One of the reasons behind jobless growth in Africa is that the continent has not gone through the normal process of structural transformation, involving a shift from low- to high-productivity activities, both within and across sectors. In the normal process of economic transformation, economies begin with a high share of agriculture in gross domestic product (GDP), and as incomes rise, the share of agriculture declines, and that of manufacturing rises. This process continues until the economy reaches a relatively high level of development where both the shares of agriculture and manufacturing fall and those of services rise. The structural change observed in Africa has not followed this process. Over the past three decades the continent has moved from a state in which agriculture had a very high share of output to one in which the service sector, particularly low-productivity activities within the sector, dominates output. This transition has taken place without any significant manufacturing development, which is critical to creating employment. It is therefore not surprising that Africa has experienced jobless growth over the past decade.

2. Another reason why Africa's recent growth has not had a profound impact on either poverty reduction or employment creation is that it has not gone hand in hand with the development of productive capacities, which is crucial for generating decent jobs and reducing poverty. These structural issues associated with the recent growth of African countries raises the question of how they can achieve the high, sustained and transformative growth necessary to reduce poverty. UNCTAD (2012) identified investment as one of the main drivers of structural transformation. Furthermore, research studies suggest that for African countries to make significant progress in reducing poverty, they would have to sustain growth rates of about 7 per cent and above in the medium to long term, and this would require investment rates of 25 per cent of GDP and above. Currently, investment rates in Africa are well below this threshold. They are also low relative to what is observed in rapidly growing developing countries. Boosting investment is therefore of strategic importance to achieve the broad development goals of African countries. It is also imperative if Africa is to achieve sustained growth and be a pole of global growth in the twenty-first century.

3. Against this background, the *Economic Development in Africa Report 2014: Catalysing Investment for Transformative Growth in Africa* explores how to boost and use investment in support of economic transformation and sustained growth in Africa. The term "investment" as used in the Report refers to total investment in the economy, which includes public and private investment. Private investment consists of investment by local private investors and foreign direct investment (FDI). The focus of the Report on total investment reflects the fact that all components of investment matter for growth and development; therefore, the focus of policy should be on how to exploit the complementarities among the various components, rather than promoting one component at the expense of the other. Some of the key findings and recommendations of the Report are highlighted in the following section.

I. Main findings

A. Low investment rates

4. The low investment rates in African countries relative to the average for developing countries is of concern, given that investment is a key determinant of long-run growth and is essential for building productive capacities, creating employment and reducing poverty in Africa. On average, the investment rate for Africa was about 18 per cent over the period 1990–1999, compared with 24 per cent for developing economies as a whole. Similarly, in the period 2000–2011, the average investment rate for Africa was about 19 per cent, compared with 26 per cent for developing economies overall.

5. The average investment rates for Africa hide substantial cross-country variation. High investment rates in the range of 25 per cent and above are rarely sustained in African countries. Over the past two decades, only a small set of these countries have sustained investment rates of 25 per cent and above, namely Algeria, Botswana, Cape Verde, the Congo, Equatorial Guinea, Guinea, Lesotho, Sao Tome and Principe, and Seychelles.

6. The majority of African countries have low investment rates. For example, over the period 2000–2011, the following countries had average investment ratios below 15 per cent: Angola, the Central African Republic, the Comoros, Côte d'Ivoire, Guinea-Bissau, Liberia, Libya, Nigeria, Sierra Leone, Swaziland and Zimbabwe. Research studies also suggest that Africa's investment rates are lower than optimal levels in the sense that they are below what is needed to sustainably reduce poverty and achieve international development goals such as the Millennium Development Goals. For example, based on some studies, an investment rate of 25–33 per cent is required for African countries to be able to reach the growth rate of 7 per cent estimated to be necessary to meet the Goals, especially the goal of reducing poverty by half by 2015. Most African countries have not been able to meet this target.

B. Structural problems with recent growth

7. On the demand side, recent growth has been driven mostly by consumption, and there has been no significant improvement in average investment rates in Africa over the past two decades. Although consumption is an important source of domestic demand and has been the dominant driver of growth in Africa over the past decade, a consumption-based growth strategy cannot be sustained in the medium to long term because it often results in overdependence on imports of consumer goods. This presents challenges for the survival and growth of local industries, the building of productive capacities and employment creation. Furthermore, it causes a deterioration of the current account balance, which would have to be corrected or reversed in the future to maintain external sustainability. Experience has shown that reversals of such current account imbalances often require drastic reductions in consumption, which have a severe negative impact on growth. While investment booms can also deteriorate the current account, recent evidence suggests that current account deficit reversals caused by investment booms that increase the production capacity for tradable goods are associated with better growth performance than those driven by consumption booms (Klemm, 2013).

8. There are also structural problems with Africa's recent growth from a supply or sectoral perspective. For example, it has not been transformative. Although Africa has had high and steady growth over the past decade, many countries have yet to go through the normal process of structural transformation, characterized by a shift from low- to high-productivity activities, as well as a declining share of agriculture in output and employment

and an increasing share of manufacturing and modern services in output. Available data indicate that the share of manufacturing in total value added has declined over the past two decades. It fell from an average of 14 per cent in the period 1990–1999 to 11 per cent in the period 2000–2011. Furthermore, the service sector is now the most dominant sector of African economies. Its share of total value added in the period 2000–2011 was about 47 per cent, compared with 37 per cent for industry and 16 per cent for agriculture. In terms of dynamics, over the same period the service sector had an average growth rate of 5.2 per cent, agriculture, 5.1 per cent and industry, 3.5 per cent. Since the service sector has the highest growth rate as well as a higher share of total value added, its contribution to growth has been higher than those of other sectors.

9. This pattern of structural change differs substantially from what one would expect, since Africa is still in an early stage of development. As a rule, the service sector in the early stages of development does not play such a dominant role in an economy. Furthermore, the dominance of the service sector should be of concern because it is driven mostly by low-productivity activities such as informal and non-tradable services. These facts suggest that Africa's recent growth is fragile and is unlikely to be sustained in the medium to long term if current trends continue.

C. Increased productivity of investment

10. The incremental capital–output ratio (ICOR), which measures the degree of inefficiency in the use of capital, suggests that there has been a significant increase in the productivity of aggregate investment over the past two decades. The ratio is computed in such a way that a higher value for an economy indicates lower productivity. Available data indicate that in the period 2000–2011 the ICOR for Africa was 4.1, compared with 7.4 in the period 1990–1999. This represents a significant increase in the productivity of investment in Africa. The data also indicate that compared with other developing-country groups, the productivity of investment in Africa in the period 2000–2011 was much higher than those of developing countries in America and slightly higher than those of Asia.

11. This represents a big shift compared with the 1990s, when investment was less productive in Africa than in other developing-country groups. While there has been a significant improvement in the productivity of investment at the aggregate level, there were 22 African countries for which the productivity of investment either did not change or declined between 1990–1999 and 2000–2011, indicating that more effort will be needed by African countries to sustain or improve upon the recent increases in the productivity of aggregate investment.

D. Public investment matters for growth

12. It is often argued that what matters for growth is private, not public investment. However, results of country-level studies using African data indicate that public investment also matters for growth in Africa and catalyses or complements private investment. For example, Samake (2008) found that public investment crowds in private investment and both types of investment have a significant impact on growth in Benin. Similar evidence has also been provided for Cameroon (Ghura, 1997). Other studies have found that public capital is generally productive and boosts output at the sectoral or national level. An example is the study on South Africa by Fedderke et al. (2006). Additional supportive empirical evidence on the role of public investments in the growth process in Africa can be found in Fosu et al. (2012). These findings confirm the strategic role of public investment in the growth process.

E. Decline in public investment rates

13. Compared with the early 1980s, public investment rates in Africa have declined sharply over the past two decades. In particular, public investment rates fell from a peak of 11.5 per cent in 1982 to about 5 per cent in 2012. Unlike in the 1980s, public investment rates in Africa were relatively stable in the 1990s and 2000s, with the average rate being about 7.5 per cent in each of these two decades.

14. These numbers are below what a recent study suggests is optimal for Africa. For example, simulations of growth models show that the public investment rate that maximizes consumption is between 8.4 per cent and 11 per cent, depending on the discount rate used (Fosu et al., 2012). At the country level, the evidence shows that public investment rates in at least 23 countries have fallen over the past two decades, with the most dramatic declines observed in the following countries: Cape Verde, from 18.1–13 per cent; Egypt, from 14.5–8.2 per cent; Eritrea, from 17.6–13.4 per cent; and Lesotho, from 18.2–9.1 per cent.

F. Unlocking investment potential for transformative growth

15. A review of the literature on African economic development suggests that the main determinants of investment in Africa are access to credit and the cost of finance, domestic savings, risk and uncertainty, inequality of income distribution, and the policy and investment environment as reflected, for instance, in the level and quality of infrastructure. Clearly, given the heterogeneity of African countries, the relative importance of these factors varies from country to country. Nevertheless, the Report finds that the most binding constraints to investment in most African countries are weak access to affordable finance, poor infrastructure, and risk and uncertainty.

G. Decrease in external finance

16. African countries have historically used external finance such as FDI, debt and official development assistance to complement domestic resources for investment. This is evidenced by the continent's positive investment–savings gap over the past few decades. For example, in the period 1980–1989, the investment–savings gap of Africa as a percentage of GDP was 1.2 per cent. More recently, the gap has narrowed significantly. In particular, for the period 2000–2011, Africa had a negative investment–savings gap of about 2.8 per cent, reflecting the fact that more investment is financed through domestic sources.

17. Oil-rich African countries exhibit a substantial surplus of savings over investment, with an average ratio of savings to investment of 158 per cent for the period 2000–2012. In contrast, non-oil-rich African economies have a low ratio of savings to investment of 17.2 per cent over the same period. The ratio of savings to investment has increased substantially for oil-rich countries, especially since the 1980s, spiking during oil-boom episodes.

18. African countries also depend on official development assistance to finance investment more than their counterparts in other developing countries. The ratio of official development assistance to investment over the period 2000–2012 was 68.8 per cent for Africa, compared with 23.1 per cent for other developing countries. The gap is even larger for public investment: 239.3 per cent for Africa, compared with 84.3 per cent for other developing countries. However, African oil-rich countries appear to rely less on official development assistance, with a ratio of 34.9 per cent in 2000–2012, compared with 78 per cent for non-oil-rich countries.

19. African countries also exhibit higher ratios of debt to investment, compared with other developing countries. There are less distinguishing patterns regarding the FDI-to-investment ratio. Oil-rich countries exhibit slightly higher ratios, consistent with the tendency for resource seeking observed in FDI in African countries.

II. Main messages and recommendations

20. An analysis of Africa's economic growth over the past two decades suggests that it is fragile due largely to the structural nature of the growth. Against this backdrop, the Report argues that sustaining growth for employment and poverty reduction in Africa in the medium to long term requires structural transformation and that investment is a major driver of transformation. According to the Report, achieving sustained and transformative growth in Africa requires broadening its sources of growth on the demand and supply sides of the economy. On the demand side, this means balancing the contributions of consumption and investment to the growth process. On the supply side, it involves inducing a shift from low- to high-productivity activities, both within and across the agriculture, manufacturing and service sectors.

21. Another message of the Report is that enhancing the contribution of investment to growth in Africa requires increasing the quantity of investment, improving the productivity of existing and new investment, and ensuring that it is directed to priority and strategic sectors. In particular, the Report argues that increasing the level and rate of investment without enhancing the productivity of such investment over time, and also ensuring that it goes to strategic sectors, will be counterproductive. Importantly, there is a need for more public investment in Africa, particularly in infrastructure, to catalyse private investment. In this context, public and private investments are complementary; therefore, the focus of government policy should be on how to exploit these complementarities rather than on promoting one at the expense of the other.

22. The Report stresses that African governments have to adopt a more coherent approach to promoting investment if they are to play an effective role in economic transformation in Africa. In particular, macroeconomic policies should not result in prohibitive interest rates that hinder investment, and interest rates on government securities should not be so high that they incentivize banks to hold excess reserves and reduce lending to the private sector. Furthermore, African countries need to change their approach to promoting FDI because it discriminates against local investors and has negative consequences for local entrepreneurship and investment. African governments offer generous incentives to foreign investors that put local investors at a disadvantage and go against efforts to promote domestic entrepreneurship and investment. In this regard, there is a need for coherence between policies to promote FDI and those aimed at developing local entrepreneurship.

23. In addition to the messages discussed above, the Report makes specific policy recommendations on how to catalyse investment for transformative growth in Africa. Some of the policy recommendations addressing issues at the national and regional levels are highlighted below.

A. Boosting the level and rate of investment

24. There is a need for African countries to increase the level and rate of investment. This requires the adoption of a more coherent macroeconomic policy framework that, for example, balances the objective of maintaining price stability with that of promoting growth and employment.

25. It is also essential to reverse the policy bias against public investment, which has been prevalent in Africa since the 1980s because public investment, particularly in infrastructure, is urgently needed to catalyse private investment. In this regard, the Report encourages African governments to strengthen efforts to enhance domestic resource mobilization to create fiscal space to boost public investments in infrastructure, particularly in energy and transport where it has been very challenging to attract private sector investment.

26. Some of the policy measures for enhancing domestic resource mobilization are as follows: broadening the tax base by exploiting the potential to increase tax revenue through property and environmental taxes, improving tax and customs administration, developing and strengthening the financial system, and managing and using natural resource wealth more effectively.

27. Addressing imperfections in credit markets that make it difficult for enterprises to access loans at affordable interest rates is crucial for boosting investment in African countries. In several of those countries, access to credit is difficult, and commercial banks tend to hold excess reserves rather than lend to the private sector. Furthermore, bank loan rates are so high that they hinder investment. One way to reduce the incentives that banks have to hold excess reserves in the form of government securities is to ensure that the returns on such securities are not very high. Reducing information asymmetry between lenders and borrowers by strengthening support for the establishment of private credit bureaux and movable collateral registries will also help. Further, the establishment of partial guarantee schemes can play an important role in encouraging banks to finance private sector investments.

28. The Report stresses the need to enhance access to long-term finance by establishing and strengthening development banks at the national and regional levels. However, it cautions that if these banks are to succeed they have to have flexible mandates and operational autonomy, adhere to sound governance and management practices, and have a credible mechanism for assessing performance on a regular basis. It also acknowledges the potential role of capital market development in enhancing access to long-term finance in Africa. For example, it can facilitate the channelling of long-term savings from pension funds and insurance into long-term investments. Given the small size of African economies, however, capital markets are more likely to be effective if they are developed at the regional level.

29. Reducing risk and uncertainty facing local and foreign investors is also crucial to boosting investment in Africa. Political instability, macroeconomic volatility and policy reversals are all sources of risk and uncertainty in Africa, and they have negative consequences for investment. For example, macroeconomic instability can lead to large fluctuations in real interest rates and make lending and investment challenging. Addressing the issue of risk and uncertainty will require reducing the incidence of policy reversals, making more efforts to ensure that information on government policies are widely disseminated to the public, reducing macroeconomic instability, and maintaining peace and security.

30. Mitigating uncertainty in monetary policy by, for example, tying interest rate changes to movements in real variables such as real output growth or employment can also enhance transparency in policy rate setting, reduce uncertainty and encourage firms to invest in long-term projects. Better information on rules and regulations governing investment as well as investment opportunities will also reduce uncertainty and contribute to promoting investment. Although the primary responsibility to provide information rests with the government, the media can also play an important role in this area.

31. Investment demand depends on the policy and investment environment, as reflected for example by the availability and state of infrastructure. Firms have an incentive to invest if they know that infrastructure is available and of good quality. The state of infrastructure also affects the incentives for banks to lend to the real sector. For instance, in countries with severe power outages, banks are reluctant to finance projects in agribusiness and manufacturing because the likelihood of non-performing loans in these sectors will be high. Public investment in infrastructure is therefore important to boost investment. Other policy recommendations for spurring investment include reducing inequality in the distribution of income and assets, and strengthening regional integration and the development of regional production networks.

B. Ensuring that investment goes to strategic and priority sectors of the economy

32. Certain activities and sectors are critical to building productive capacities and achieving sustained and transformative growth. These include infrastructure and production activities in the agriculture and manufacturing sectors. The national development plans, visions or frameworks of most African countries identify these as strategic or priority sectors. However, commercial banks and financial institutions in Africa are generally reluctant to finance projects in these sectors, preferring to lend to the non-production sectors.

33. In this regard, one of the challenges facing African governments is how to promote investment in the strategic or priority sectors by redirecting financial resources into these sectors. The Report argues that industrial policy has an important role to play in achieving this goal. It suggests that central banks can encourage lending to strategic sectors by adopting a refinancing (discount) policy that favours lending to these sectors. The policy involves setting a differentiated discount rate that is lower for bank advances dedicated to financing investment in strategic sectors or activities. Another way to redirect investment to the strategic sectors, particularly in the case of small and medium-sized enterprises (SMEs), is to encourage financial institutions to use the flow of remittances as collateral for SMEs that seek finance for productive investments. The establishment of partial-credit guarantee schemes can also increase the flow of funds to strategic sectors and groups such as SMEs. There are also non-financial measures that governments can take to promote investment in the strategic sectors, one of which is the provision of market information and investment opportunities available in those sectors.

C. Improving the productivity of investment

34. Enhancing the contribution of investment to growth and transformation is not about increasing the quantity of investment alone – it is also about improving the productivity or quality of existing as well as new investments. While there is some evidence that the productivity of investment in Africa has improved over the past two decades, it either remained stable or declined in many African countries over the same period. Against this backdrop, the Report underscores the need for African governments to strengthen efforts to enhance the productivity of investment.

35. With regard to enhancing the productivity of private investment, the Report argues that developing workforce skills, providing good infrastructure, enhancing access to affordable credit and reducing the high costs of factor inputs are ways to tackle the challenge. To raise the productivity of public investment, particularly in infrastructure, the Report recommends better project selection and delivery, and getting more value out of existing infrastructure through maintenance of assets and more targeted public investment.

This could be achieved by refocusing public investment in areas such as energy and transport, which are some of the binding constraints to boosting investment in Africa.

36. While the responsibility for catalysing investment to transform Africa rests with national governments, there are issues with an international dimension that have a bearing on their ability to achieve their development goals. These include FDI, capital flight, aid and international trade. The policy recommendations of the Report in each of these areas are discussed below.

D. Strengthening linkages between local and foreign enterprises

37. African countries experienced a significant increase in FDI inflows over the past decade but there are concerns that the developmental impact has been limited due in part to weak linkages between foreign and local enterprises. The lack of availability of adequate infrastructure and skilled labour, low absorptive capacity, policy incoherence and the lack of a vibrant domestic private sector are some factors responsible for the weak linkages between local and foreign enterprises in Africa. African governments should create and strengthen linkages by developing and improving workforce skills, as well as raising the absorptive capacity of local firms, for example, through the imposition of technology transfer requirements on FDI. There is also a need to promote joint ventures between local and foreign enterprises and make FDI policy consistent with the promotion of domestic entrepreneurship. In this regard, the Report suggests that African governments should not promote FDI in a manner that discriminates against local investors. Furthermore, if incentives are to be used to promote FDI, they should be used mainly for attracting new investments in activities where a country cannot attract investors without such incentives. For example, in most cases incentives are not necessary to attract FDI in the extractive industry because such investments will take place regardless, given the high demand for resources and investor interest in the sector.

E. Stemming capital flight to boost investment

38. Africa loses significant amounts of resources each year in the form of capital flight. The Report underscores the need to address the problem of capital flight to release more resources for investment in Africa. Efforts are required at the international, regional and national levels to curb capital flight. For example, international cooperation is needed to prevent tax evasion and the illicit transfer of capital across borders.

39. Some measures were taken recently at the regional and international levels to address this issue. For example, in 2013 the Group of Eight made a commitment to fight tax evasion at the national and international levels. They also committed to introducing rules to ensure that multinational companies do not shift profits across borders to avoid taxes. At the continental level, African regional organizations set up the High-level Panel on Illicit Financial Flows from Africa to advise governments on the nature and magnitude of these flows and offer insights on how to tackle the challenge.

40. The Report stresses the need for African governments to improve tax and customs administration, ensure transparency in management and use of natural resources, and rethink their FDI promotion policy to ensure that multinational corporations that receive incentives do not contribute to illicit financial flows.

F. Using aid to stimulate investment

41. Aid can have a more positive impact on development in Africa if, for example, it is geared more towards stimulating investment by using it as a guarantee mechanism to reduce the risks faced by lenders and investors. Banks are often reluctant to lend to investors because of the risks involved. The use of official development assistance to provide partial guarantees to banks will encourage them to lend, thereby increasing investment. The Report stresses the need for more aid to be channelled to the production sectors to build productive capacities on the continent. Another recommendation is to encourage development partners to use more aid to lift infrastructure constraints, particularly in energy and transport, as was recently done by the United States of America through the Power Africa initiative.

G. Stimulating investment by fostering international trade

42. African countries can also boost investment by fostering international trade. Access to a larger market through trade will allow African countries to exploit economies of scale associated with producing for a large market, thereby enhancing their competitiveness and stimulating investment. In this regard, the Report underscores the need for the international community to grant African countries more market access, particularly in areas such as agriculture, where they currently have a comparative advantage. However, enhanced market access will be of benefit to African countries only if they have the productive capacity to take advantage of the opportunities arising from such access. Therefore, it is important to build productive capacities in Africa also for better information sharing on available market access opportunities so that African entrepreneurs can take more advantage of these opportunities.

43. As high international trade costs have a negative impact on trade and investment in Africa, it is important for the international community to provide financial and technical support to African countries to enable them to implement the Agreement on Trade Facilitation adopted by members of the World Trade Organization in Bali in December 2013. The Report also emphasizes the need for African governments to take a more coherent approach to the various trade negotiations and agreements they are engaged in to ensure that the outcomes are mutually supportive of economic transformation and development in Africa.

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